

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE:	\$	
	\$	
EAST TEXAS HEALTHCARE, INC.,	\$	CASE NO. 98-38547-SAF-7
et al.,	\$	(JOINTLY ADMINISTERED)
DEBTORS.	\$	
	\$	
DIANE G. REED and JOHN LITZLER,	\$	
PLAINTIFFS,	\$	
	\$	
vs.	\$	ADVERSARY NO. 02-3381
	\$	
HELLER HEALTHCARE FINANCE,	\$	
INC., et al.,	\$	
DEFENDANTS.	\$	

MEMORANDUM OPINION AND ORDER

In this adversary proceeding, John Litzler, the Chapter 7 trustee for the bankruptcy estate of Chartwell Healthcare Inc., and Diane G. Reed, the Chapter 7 trustee for the bankruptcy estates of thirty-seven Chartwell subsidiaries, filed a complaint against Heller Healthcare Finance, Inc., defendant, to determine whether Heller's security interest attached to certain settlement proceeds. Trustee Litzler and Heller settled all claims and disputes relating to the Chartwell bankruptcy estates. Accordingly, Trustee Reed is the remaining plaintiff. She seeks a declaratory judgment

that Heller has no valid or enforceable security and/or cash collateral interest in (1) the claims asserted by the trustees in the action known as the "D&O Action" against the director and former officers of Chartwell and the Chartwell subsidiaries, (2) the D&O policies, or (3) the proceeds of the D&O policies; and that Heller has no valid or enforceable security or cash collateral interest in the D&O settlement proceeds. The trustee further requests that the court enter a judgment against Heller for the recovery of the trustee's attorney's fees and court costs. The court conducted a trial of the adversary proceeding on January 31, 2003. The parties submitted the issues to the court on a joint pre-trial order, joint exhibit list, and stipulated facts.

A proceeding to determine the validity, extent, or priority of liens on property of a bankruptcy estate constitutes a core matter over which this court has jurisdiction to enter a final judgment. 28 U.S.C. §§ 157(b)(2)(K) and 1334 (2002). This memorandum opinion contains the court's findings of fact and conclusions of law. Bankruptcy Rule 7052.

Factual Background

Trustee Reed has pending a fraudulent transfer action against Heller and other parties ("Heller Action"), in which she seeks a determination of the validity, extent and priority of Heller's claimed security interests in funds held by Trustee Reed on behalf of the Chartwell subsidiaries' bankruptcy estates. The determination of this adversary proceeding is without prejudice to the adjudication of the Heller Action.

The trustees had filed and prosecuted an adversary proceeding, the "D&O Action," against the director and former officers of Chartwell and the Chartwell subsidiaries. The trustees settled their claims in the D&O Action through two separate settlement agreements: (1) relating to the trustees' claims against all of the defendants named in the D&O Action except Irving Boyes and Stephen Morehead, and (2) relating to the trustees' claims against Boyes and Morehead. According to the terms of the first settlement, Zurich American Insurance Company paid each trustee \$87,500 in their representative capacities as Chapter 7 trustees for Chartwell and the Chartwell subsidiaries, for a total of \$175,000. Pursuant to the terms of the second settlement,

Zurich and the Federal Insurance Company paid each trustee \$600,000 in their capacities as Chapter 7 trustees for Chartwell and the Chartwell subsidiaries, for a total of \$1,200,000. The source of the settlement payments includes proceeds from two insurance policies: Zurich's directors and officers liability and company reimbursement policy no. 365875601 and Federal's directors and officers liability and reimbursement excess policy no. 7940-22-85.

Heller's Lien

Prior to the Chartwell debtors' bankruptcy filings, Chartwell and Heller entered into a loan and security agreement on February 11, 1998. Heller made a revolving credit loan to the Chartwell debtors in the maximum aggregate principal amount of \$10,000,000. As security for repayment under the loan agreement, Chartwell granted Heller a first and prior lien on and security interests in property owned by the Chartwell debtors, including, "among other things, all of the Chartwell debtors' choses in action, claims of any kind, contract rights, general intangibles, rights and claims under insurance policies, and other rights to payment of any kind, and all proceeds therefrom." Joint pretrial order at 7.

With the filing of the Chartwell debtors bankruptcy cases, all of the causes of action that belonged to the debtors became property of the bankruptcy estates. 11 U.S.C. § 541(a); In re Segerstrom, 247 F.3d 218, 223-24 (5th Cir. 2001). As trustee for the bankruptcy estates of the Chartwell subsidiaries, Reed prosecuted the debtors' causes of action. 11 U.S.C. § 323. Heller had a lien on the proceeds of those causes of action based on the February 11, 1998, loan agreement.

D&O Settlement Proceeds

Trustee Reed asserts that the D&O Action was filed by the trustees in their capacities as Chapter 7 trustees for the bankruptcy estates of the Chartwell debtors, and on behalf of the creditors of the Chartwell debtors. Because she brings the actions on behalf of the creditors, Trustee Reed alleges that the claims asserted in the D&O Action were not claims belonging to the Chartwell debtors. If the causes of action are not property of the bankruptcy estates, Heller's security interest in the assets of the Chartwell debtors would not include the claims asserted by the trustees in the D&O Action or the D&O settlement proceeds. Trustee Reed further alleges that Heller cannot claim a

security interest in the resulting D&O settlement proceeds based upon any claimed security interest in the Chartwell debtors' insurance policies since Heller never perfected a security interest in the D&O policies or the proceeds of the insurance policies. According to Trustee Reed, the D&O settlement proceeds are therefore not "proceeds" of Heller's collateral within the meaning of Tex. Bus. & Com. Code §9.306(a).

Heller responds that the D&O Action involved causes of action belonging to the Chartwell debtors and thus Heller's liens attach to the proceeds of the causes of action. Heller does not claim a security interest in the insurance policies or proceeds therefrom. Rather, Heller claims a security interest in the D&O causes of action and the proceeds therefrom. Heller argues that its security interest attaches to funds when paid to settle the D&O claims, regardless of the source. Heller further argues that the trustee lacks standing to prosecute claims, if any, belonging to individual creditors of the Chartwell debtors. Heller is correct on all points.

Trustee Reed contends that the Chartwell debtors' director and officers had a fiduciary duty to each

corporation and its shareholders. However, when the Chartwell debtors entered a zone of insolvency, the fiduciary duty shifted from the corporation and its shareholders to the corporation and its creditors. See In re Hechinger Inv. Co. of Delaware, 280 B.R. 90, 92 (D. Del. 2002). The trustee contended in the D & O Action that the director and officers breached that fiduciary duty. Because the Chartwell debtors had been within the zone of insolvency, the trustee maintains that she brought the causes of action on behalf of the creditors.

Indeed, as trustee of the bankruptcy estates, Trustee Reed does ultimately act on behalf of the creditors and other parties in interest. Notwithstanding that, Trustee Reed prosecuted claims belonging to the corporations and thereafter the bankruptcy estates. Before the bankruptcy cases, the facts underlying the D&O Action may have given rise to a breach of fiduciary duty to the corporations, which may have been brought derivatively by creditors, if in the zone of insolvency, and to a breach of fiduciary duty to individual creditors. See In re Schimmelpenninck, 183 F.3d 347, 359-60 (5th Cir. 1999). The causes of action for breach of fiduciary duty to the corporations became property

of their bankruptcy estates, which the trustee would liquidate. The causes of action, if any, for breach of fiduciary duty to individual creditors remained the property of those individual creditors.

The D&O claims brought by the trustee were all pre-petition claims that belonged to the debtors. The D&O settlement therefore liquidated claims that had belonged to the debtors and had become property of the bankruptcy estates. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 349 (3rd Cir. 2001) (concluding that the claims brought by the committee belonged to the debtors, rather than to the creditors).

The trustee has presented no evidence that any individual creditor assigned or otherwise transferred its individual causes of action to the trustee to liquidate in the D&O Action. Absent a transfer of the individual creditors' causes of action to the trustee to be prosecuted on behalf of the bankruptcy estates, the trustee lacks standing to prosecute any individual creditors' causes of action. See Schimmelpenninck, 183 F.3d at 359 (holding that trustee lacks standing to assert personal claims of creditors because they are not property of the estate);

Ocean Energy II, Inc. v. Alexander & Alexander, 868 F.2d 740, 747 (5th Cir. 1989) (holding that directly harmed individual creditors have standing to assert RICO claims, rather than those persons suffering derivatively from fraud perpetrated on a corporation or a bankruptcy estate).

Insurance Proceeds

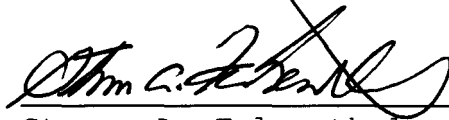
The two settlement agreements reached in the D&O Action were funded by the Zurich and Federal insurance proceeds. Trustee Reed asserts that Heller does not have a lien on the Zurich or Federal insurance policies. Liens on insurance policies and their proceeds are secured by assignment. See United Presidential Life Ins. Co., v. Barker, 31 B.R. 145, 146 (N.D. Tex. 1983) (holding bank's lien on assigned insurance policy survived debtors' discharge in bankruptcy); In re Epps, 25 B.R. 115, 116 (Bankr. N.D. Tex. 1982) (holding bank had properly perfected security interest in insurance policies written by debtor where bank had accepted written assignment and had obtained written recognition of the assignments by the insurers). Since Heller did not obtain an assignment of either the Zurich or Federal insurance policy, Heller does not have a lien on the insurance policies or their proceeds.

The lack of a lien on the insurance policies and their proceeds does not resolve the issue. Heller does have a lien on the causes of action liquidated by Trustee Reed. Heller's lien reaches the proceeds of those causes of action. Zurich and Federal paid insurance proceeds into a settlement fund to resolve causes of action belonging to the bankruptcy estates. The defendants in the D&O Action in effect used the insurance proceeds to pay the claims brought against them by the trustee. When the insurance proceeds became settlement proceeds, Heller's lien attached to the settlement proceeds. In re Simmons, 765 F.2d 547, 556 (5th Cir. 1985); In re Quality Holstein Leasing, 752 F.2d 1009, 1012 (5th Cir. 1985); In re Bensen, 262 B.R. 371, 378-79 (Bankr. N.D. Tex. 2001). It matters not where the dollars came from to fund the settlement of the causes of action belonging to the bankruptcy estates, rather, once funded, Heller's lien attached. Thus, while Heller could not attempt to claim the insurance policies or their proceeds directly as its collateral to be applied to the Chartwell debt, Heller does have a lien on the proceeds of the D&O causes of action belonging to the debtors, now the estates.

Based on the foregoing,

IT IS ORDERED that Trustee Reed's request for declaratory relief is **DENIED**. Heller shall have a judgment declaring that its liens attach to the subject settlement proceeds, but without prejudice to the adjudication of the Heller Action. Counsel for Heller shall prepare a final judgment in conformity with this order.

Dated this 11th day of March, 2003.

A handwritten signature in black ink, appearing to read "Steven A. Felsenthal", written over a horizontal line.

Steven A. Felsenthal
United States Bankruptcy Judge